Farm Corporations

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Factsheet

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INTRODUCTION

In Ontario the number of farm businesses that are incorporated has been growing steadily as farm businesses become larger and the corporate tax rate continues to fall. This Factsheet will help farm business owners to understand the corporate structure and to decide if incorporation makes sense for their farm business.

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SECTION 1 — THE BASICS OF INCORPORATION

WHAT IS A CORPORATION?

A corporation is a "separate legal entity," which means it can do anything a person can. It can:

- carry on business
- buy, own and sell assets
- hold mortgages and have debt
- file income tax returns
- rent land or other assets from you
- rent assets to you
- enter into contracts

ADVANTAGES AND DISADVANTAGES OF INCORPORATING?

There are both advantages and disadvantages to the corporate business structure. Farm businesses should consider not just the tax advantages, although these are often the main reason for considering incorporation. See Table 1 for a summary of the advantages and disadvantages.

Deferring Tax

An important point to understand is that much of the tax advantage of incorporation is from deferral of tax. This means that at some point in the future when the money is removed from the corporation tax will have to be paid. However, the longer the deferral the greater the advantage. If the business is not expected to continue beyond a five-year time horizon then the cost of incorporating may not make sense.

Deferring tax is possible because the corporation is taxed at 16.5 per cent on the first $500,000 on active business income. On July 1, 2010 this rate will drop to 15.5 per cent. However, this lower rate is of no advantage if the shareholder(s) must remove all of the company profits for living expenses, since the money would then be taxed at personal rates that are higher than the corporate rate. Table 2 demonstrates how a tax deferral might be achieved in a company with three shareholders and a net income of $150,000. In the example there is approximately a $9,900 advantage by taking minimal salary and retaining profits in the corporation. This example does not take into account the additional tax credits that the individuals may be able to access at the lower personal rates.

Repayment of Debt

Savings from deferred tax can be used to finance the ongoing operations of the business. If this additional cash can be used to repay debt in a shorter timeframe then there is a true savings on interest paid. This is why it is desirable to have the corporation hold as much of the farm business debt as is practical.

Maximize Personal Tax Credits

Corporate structures can allow personal tax credits of shareholders to be maximized. This is especially advantageous where shareholders have young children. Salary paid to the parents can be kept at a level that maximizes the child tax benefit and other credits.

Ministry of Agriculture, Food and Rural Affairs

Ontario

Table 1. Advantages and Disadvantages to Incorporating a Farm Business

Advantages	Disadvantages
Tax advantage — the corporate tax rate is lower than the highest personal rates so there is a tax deferral on money that is left inside the corporation. The longer you defer the payment of taxes the greater the advantage. There is also the opportunity to maximize shareholders personal credits.	**Complexity** — the structure is more complex and requires more professional advice.
Possible Faster Repayment of Debt — because the corporation is taxed at a lower rate it can pay off the debt faster than the individual who is making the payments with after tax dollars paid at a higher personal rate.	**Loss of Capital Gain Exemption** — a corporation does not have any capital gains exemption.
Liability — there are some advantages to be gained from the limited liability however most lenders require personal guarantees so the individual remains liable for the corporate debts.	**Initial and Ongoing Costs** — since the corporation must also file tax statements in addition to the shareholder the ongoing costs are usually higher.
Perpetual Succession — a corporation has perpetual existence that can allow for a smooth transfer between generations over a period of time.	**Loss of Personal Tax Benefits** — if land is placed inside the corporation there is a potential loss of the capital gains exemption on the principle residence.
Flexibility — the structure is highly flexible in terms of assets owned and payment of shareholders.	
Capital Gains Exemption Utilization — the personal capital gains exemption can be utilized on transferring assets into the corporation and is available on the sale of the shares of the corporation.	

Table 2. Tax Deferral Example

	All corporate income paid out as salary	Minimal salary with the remainder held in corporation
Personal Income	50,000 each = $150,000	$30,000 each = 90,000
Income Tax – personal	~ $ 39,000[1] (average 26%)	~ $ 19,800[1] (average 22%)
Profit left in company		$ 60,000
Corporate tax (60,000 x 15.5%)		~ $ 9,300
Net amount remaining in corporation (60,000 – 9,300)		$ 50,700
Total Tax paid	~ $ 39,000	~ $ 29,100
Tax Deferral		$ 9,900

Complexity vs. Simplicity

A corporate structure may be beneficial from a tax perspective but it can also introduce more complexity than the business owners want. Business owners should determine if they are comfortable with:

- learning new terminology such as shareholder loans, dividends, common and preferred shares
- no longer directly owning all the assets of the business
- keeping personal financial affairs separate from the corporation
- depending more on advisors for dealing with the tax and technical issues of the business

Limited Liability

A corporation may provide some limit to legal and financial liability. If the corporation fails to pay its debts, a creditor will pursue the corporation's assets offered as security. However if the corporation does not own enough assets to satisfy lenders security requirements they will often require shareholders to personally guarantee corporate loans which means that the lender can pursue their personal assets. If no guarantee is in place then personal assets are protected.

In the case of a lawsuit for damages the corporation is sued and not the shareholders. Liability insurance can protect against such a claim. However the corporation may not provide complete protection from legal liability. There are cases where the courts have held shareholder executives personally liable for the actions of the corporation.

$750,000 Capital Gains Exemption

Concern about the elimination of the capital gains exemption motivates some to consider incorporation. This is because a capital gain can be triggered as assets

are transferred to the corporation and the capital gains exemption utilized to offset the gain. This is sometimes referred to as "crystallizing" the capital gain.

While the exemption is an important tax benefit it should not be the sole reason to incorporate. Corporations do not have any capital gains exemption available to them so the future capital gains on the sale of an asset by the corporation will be taxed in the corporation. Fifty percent of the gain is still tax free for the corporation and that portion can be distributed to the shareholders on a tax free basis.

The $750,000 capital gains exemption is available for qualified farm properties that include:

- farm land and buildings
- shares in a family farm corporation
- an interest in a family farm partnership
- quota (referred to as eligible capital property)

While the corporation itself has no capital gain exemption, the shares of the corporation are eligible. This means that the exemption could be used on the sale of corporate shares.

For more detail on the capital gains exemption refer to the OMAFRA Factsheet *Taxation on the Sale of Farm Business Assets*, Order No. 08-047.

WHEN SHOULD YOU INCORPORATE?

As a rule of thumb, when family income — farm and non farm — reaches approximately $75,000 the tax advantages may merit investigating incorporation. This is because the personal marginal tax rate above this level is approaching 40 per cent. In addition not all of the income above this level may be required for family living and thus can be remain in the corporation to be taxed at the lower corporate rate.

SECTION 2 — FORMING A NEW CORPORATION

Forming a corporation involves three areas that require thoughtful discussion. These are:

- share structure
- shareholder agreement
- personal or corporate ownership of assets

SHARE STRUCTURE

Share structure refers to the type and properties of the shares of the corporation. Most importantly the share structure will determine the control of the business, how dividends are distributed and who participates in the growth of the business. In corporations with only one shareholder this is quite simple. As the number of shareholders increases, and in particular when a second or third generation is involved, it becomes more important to have a share structure that is fair to everyone, and defines the ownership and control of the farm corporation.

Types of Shares

Common or growth shares: represent the net value of the assets after the corporate debts and value of special shares are deducted. Any future growth or decrease in value affects the value of the growth shares. Often these shares will have voting rights attached, although in some cases parents may hold special shares that do not grow in value but have voting rights attached. This allows them to maintain control of the business and at the same time enable the children to participate in the growth of the business.

Special Shares: are often referred to as preferred shares, have a fixed value and may bear dividends. A dividend is a pay out on a per share basis to the shareholder. Special shares are set at a fixed value and do not fluctuate in value as the company grows.

Share Rights

If the corporation has more than one class of shares then the rights and privileges of each class must be determined. The right to vote and receive the remaining property must be attached to at least one class of shares although both do not need to be attached to the same class. Any share can have rights assigned or attached to it. These rights should be listed in the articles of incorporation or corporation bylaws. Some of the more common rights that can be attached to shares include:

Redeemable Shares: This gives the shareholder a right to redeem or sell back to the corporation their redeemable shares. Other conditions, such as the number of shares that can be redeemed in one year, notice period prior to redemption, etc. may also be stipulated.

Retractable Shares:
A retractable share gives the corporation the right to buy back shares. Special or preferred shares would typically be "retracted" at the par or cumulative value. A predetermined price or predetermined method of calculating a value would be used to value the common shares.

Cumulative Shares: Some shares are entitled to a dividend payment each year. However, there may be

years where the corporation does not pay dividends. If the shares are cumulative the dividend not paid will still by owed to the shareholder. In other words, the corporation is obligated to pay the dividend in the next or future years. The dividends not paid would accumulate until paid.

Non-Cumulative Shares: For a non-cumulative share, the corporation is not obligated to pay "missed" dividends in future years. In other words, unpaid dividends do not accumulate.

SHAREHOLDER AGREEMENT

The shareholder agreement outlines how the corporation will operate. It usually covers the establishment, operation and termination of the corporation. Some of the key benefits to a shareholder agreement are it:

- outlines a procedure to deal with conflict between the shareholders
- protects minority shareholders in areas not covered in the articles of incorporation or in the by-laws
- provides an important guide the heirs in the event of the death of a shareholder
- provides documentation for tax purposes

Issues that are frequently addressed are:

- rights of a shareholder to nominate directors or appoint officers
- management responsibilities
- conduct of a shareholder with respect to other business involvement
- the right to participate in future share offerings and anti dilution provisions
- the transfer of shares either to individuals or to holding companies
- rights of first refusal and buy-sell arrangements
- how the valuation of shares will be done
- death or disability of a shareholder, including clauses about life and disability insurance
- retirement timeframe for shareholders
- dispute resolution, what mechanism will be used and the consequences

TRANSFERRING ASSETS

Personal or Corporate Ownership of Assets

The choice between personal or corporate ownership of assets should be considered in light of the tax advantages, personal preferences and the degree of desired flexibility in the future. Assets can be owned personally and leased to the corporation or transferred to the corporation. This can be done in any combination that the shareholders wish. For an explanation of the tax issues and terminology refer to the OMAFRA Factsheets *Taxation on the Sale of Farm Business Assets,* Order No. 08-047 and *Taxation on the Transfer of Farm Business Assets to Family Members,* Order. No. 09-015.

Tax Implications of the Transfer

The *Income Tax Act* allows farming assets to be transferred to the corporation on a tax deferred basis as long as the appropriate elections and forms are filed with Canada Revenue Agency. This is called a "rollover" in tax terminology. The Act also allows the option to choose a price that will trigger part or all of the capital gain if the goal is to utilize the capital gains exemption .

In very simple terms, when an asset is transferred into the corporation the individual can receives a "package" made up of shares and non share consideration. This non share consideration can include a shareholder loan that the company now owes the shareholder. Usually this loan represents the "tax paid" portion of the asset. This loan can then be paid out to the shareholder on a tax free basis. Table 3 outlines some of the various transfer combinations.

Table 3. Transferring Assets Into a Corporation

Transfer Values	Result
Case 1 Transferred at the adjusted cost base (ACB)	• No capital gains triggered • Shareholder loan owed to shareholder for the amount of ACB • Special shares taken by shareholder for the amount between the ACB and FMV • If the asset is sold in the future the capital gain is calculated from the ACB.
Case 2 Transferred between ACB and FMV	• Some capital gain triggered and capital gains exemption used. • Shareholder loan to shareholder for the amount of new ACB • Special shares taken by shareholder for the amount between the new ACB and FMV
Case 3 Transferred at FMV	• All the capital gain triggered and capital gains exemption used. • Shareholder loan to shareholder taken for the full amount of FMV

Table 4. Advantages and Disadvantages to Transferring Land to a Corporation

Advantages	Disadvantages
Utilize the capital gain — transferring the land allows the use of the capital gains exemption.	**Loss of Capital Gain Exemption** — a corporation does not have a capital gains exemption. If the land does not currently have large capital gains but you expect higher gains in the future, you may want to keep land out to use the capital gain exemption in the future.
Possible Faster Repayment of Debt — because the corporation is taxed at a lower rate it can pay off the debt faster than the individual who is making the payments with after tax dollars paid at a higher personal rate.	**Loss of Flexibility on Future Transfers** — if there are two or more children involved in the business keeping the land out provides flexibility if they decide to farm separately at a later date.
Creation of Shareholder Loans — placing land inside the corporation allows you to create shareholder loans. These are paid back to the shareholder tax-free.	**Taxable Benefits** — if a personal residence is transferred into the corporation with the land the shareholder can incur taxable benefits because they have the use of the house that the corporation owns.
Business Organization — having all the assets inside the corporation may be appealing to those who want the business structure to be as straight forward as possible from a tax and legal standpoint	**Loss of Capital Gains Exemption on Personal Residence** — capital gains on a personal residence are exempt from tax. However if the corporation owns the house there is no exemption.

Table 5. Land Transfer

	Deferral with no Capital Gain Exemption Used	Capital Gain Exemption Used
A.C.B. of Land	$100,000	$100,000
F.M.V. of Land	$400,000	$400,000
Sale to Corporation	**$100,000** [1]	**$400,000** [2]
Capital Gain	0	$300,000
Taxable Capital Gain (50% of Gain)		$150,000
Taxable Capital Gain Exemption		($150,000)
Results		
Shareholder Loan	$100,000	$400,000
Preferred Shares	$300,000	$0

1. The parent might hold a mortgage for $100,000.
2. Holding a mortgage for a significant portion of $300,000 should minimize problems with minimum alternative tax as long as it qualifies as a reserve.

Example from Table 5 — A piece of land worth $400,000 transfers into a corporation. The adjusted cost base (ACB) is $100,000. The capital gain on the land is $300,000. Instead of taking a shareholder loan for just $100,000 and preferred shares on the rest the owner could take a shareholder loan for the full $400,000. This would trigger a capital gain that the owner could then apply his capital gain exemption against.

Results — The corporation gets the land at a higher ACB, which means that if the land is sold sometime in the future, the capital gain will be calculated from the $400,000. The shareholder can receive tax-free payments from the corporation on their shareholder loan.

TYPES OF ASSETS TRANSFERRED

Land

The decision between maintaining personal ownership of land or transferring it into the corporation is often difficult to make. Every situation is different. There are both advantages and disadvantages to transferring land into the corporation. Table 4 lists some of these.

In many cases land is transferred into the corporation because of the desire to trigger a capital gain and use the capital gains exemption or because a significant portion of the debt is attached to the land.

When land is transferred the parents usually trigger any gains and take back a shareholder loan up to the tax value. Payments on the loan come out of the corporation tax-free to the shareholder and so this loan

is sometimes used in estate planning to deal with non-farming kids or for the retirement needs of the parents.

There are situations where it may be advisable to leave land outside the corporation. Where there is more than one parcel of land the family may desire flexibility for estate planning reasons. Or a farm property may be in an area that is close to an urban area and the land values are expected to increase in excess of parents' $750,000 exemption. In that case the land might be left out on the chance that the children's $750,000 exemption might be used in the future.

In the example in Table 5 the land could be transferred at the adjusted cost base or at the FMV and the capital gains exemption used. If the exemption was not available, a capital gain reserve could be used to that would spread out the gain over a number of years if the parent held a mortgage.

Farm House

If land and the principle residence are transferred to the corporation a loss of the principal residence exemption for capital gains may result. As well, the corporate-owned house could result in a taxable benefit to the shareholder living in the house. Some advisors specifically exclude the house in the land transfer and then charge the shareholders rent for the land that the house sits on. In this way the principal residence exemption is preserved. On farm properties with two houses only one can be claimed as the principal residence.

Quota

A farmer can transfer quota into a corporation and claim the capital gains exemption on the increase in value. However, the increase in value of the quota cannot be added to the cumulative eligible capital account pool (which is similar to CCA classes) and depreciated. This higher value will reduce any gain on a future sale by the company. Like other assets the shareholder can hold a shareholder loan allowing tax-free payments to the shareholder.

Similar to land, if the shareholder anticipates the quota will increase in value it may be beneficial to hold the quota personally (subject to marketing board regulations), rather than in a corporation — and be able to use the capital gains exemption on a future sale or transfer. When the corporation sells the quota the proceeds will qualify for the small business tax rate of 15.5 per cent, as long as the quota was used in the active business.

Inventory

Crop and livestock inventory can transfer tax deferred into the corporation but will eventually be taxed. Some advisors suggest taking preferred shares for the value of the inventory. This means that the shareholder receives the full value of the inventory and the company pays the tax when it sells the inventory. This approach would be a disadvantage to other shareholders, since the company now holds the tax liability. If the other shareholders are children they may accept this liability especially if they obtained shares by way of gift or at a reduced rate.

A more common approach is to sell the inventory to the corporation for full value and the shareholder then takes a properly structured demand note from the company. This is advantageous for four reasons, as long as both the shareholder and corporation file income tax on a cash basis:

- The company receives a deduction when it makes payments on the note.
- The shareholder could spread the income out over any time period chosen.
- This is fair to other shareholders because the company is not paying taxes on the inventory sale by the corporation.
- The payments on the note from the corporation are business income which the shareholder must pay CPP on but are considered eligible income for calculating RRSP contributions.

Incorporating A Partnership

A partnership interest can be transferred to a corporation like any other asset or the partnership assets themselves can be rolled into the corporation. In either case there are specific rules to follow. It is important to seek tax advice.

DOCUMENTS TO CONSIDER WHEN INCORPORATING

After incorporation review all other legal documents.

Wills — If the will conflicts with the shareholder or other business agreement, the business agreement will likely take precedence. Review your will, since the assets once personally owned and bequeathed, are now owned by the corporation.

Power of Attorney — A power of attorney is a document that allows chosen individuals to act on your behalf if you become incapable of managing your

business or personal affairs. In this event, a power of attorney allows the business to continue operating with the least amount of disruption and gives other shareholders a measure of security.

Leases — If certain assets, such as land, are owned personally, and those assets are essential for the corporation to function, prepare a lease agreement between the company and the owner of those assets.

Insurance Contracts — Business insurance on the lives of key shareholders can allow the corporation to purchase the shares of the deceased shareholder from the surviving spouse, which will help minimize tax on the death of a shareholder.

SECTION 3 — OPERATING THE CORPORATION

The day to day operation of the farm business is not affected by incorporation. What does change is the relationship of the owner to the business. This is especially true when it comes to how shareholders are paid by the corporation. A corporation gives the shareholder increased options and flexibility regarding remuneration.

TAKING MONEY OUT OF THE CORPORATION

There are four ways that the shareholder can receive money from the corporation:

- salary
- dividends
- repayment of shareholder loans
- rental payments for the use of personal assets

Each of these has advantages and disadvantages as outlined in Table 6.

Dividends Versus Salary

Dividends and salary are the two most common methods of paying shareholders. If the corporation pays a shareholder salary the corporation is able to claim an expense and reduce its taxable income. The salary is then taxed in the hands of the shareholder. Salaries do not have to be paid according to percentage of share ownership. So if a shareholder only owned 20 per cent of the shares they could still receive a larger percentage of the money paid out in salaries for the work they do. In this way a parent can still pay a minority shareholder child a fair wage for their contribution to the business.

A dividend is a payment to the shareholder usually based on the number of shares that the shareholder has. The corporation pays the shareholder with money it has already paid tax on and cannot claim the dividend payment as an expense. The shareholder is able to use a dividend tax credit to offset the tax they will have to pay on dividends, since the company has already paid some tax on the amount distributed to the shareholder.

There are some important differences to consider with regards to salary or dividends. Canada Pension Plan (CPP) contributions must be paid on salary. For 2010 the CPP contributions are 9.9 per cent on income up to $42,700 (none on the first $3,500). CPP contributions are not required on dividends. Dividends on the other hand are not considered earned income for the purpose of RRSP contributions.

If the corporation is renting assets from you, rental payments can be used in calculating RRSP contributions.

What Is The Best Method?

There is no one best method. Each shareholder should talk to their tax advisor at year end to decide their best option. For instance, if you had a large enough shareholder loan you might want to receive enough income (salary, dividends or rental payments) from the company to use up your personal deductions. The additional amount require for living would be received as a repayment of a shareholder loan. This would provide both tax free income and maximum use of tax credits.

Financial Statements and Records

Filing a complete set of financial statements is required of farm corporations. This may help large complex businesses to keep their affairs in order. The corporation must file an income statement, balance sheet and statement of change in financial position.

The *Ontario Business Corporations Act* requires that certain corporate documents be kept at the registered office. These include:

- articles of incorporation, by-laws and any unanimous shareholder agreements
- all resolutions of the corporation and minutes of meetings
- a registry of security holders and shareholders with appropriate details of each
- a registry of directors
- a registry of share transfers
- accounting records

Table 6. Payments to Shareholders

Method of Payment	Advantages	Disadvantages
Salary	• Can take out just enough to use up the lower tax bracket • Can use to contribute to an RRSP • Can use to contribute to CPP if desired • Salary payment is a deduction for the corporation	• Must make CPP contributions on salary. • If the salary is significant then higher personal tax rates will apply.
Dividends	• Taxed at a lower tax rate than salary	• CPP does not need to be paid • Dividends are not a deduction for the corporation
Repayment of a shareholder loan	• The repayment of a shareholder loan represents principal payments on an asset that the shareholder has sold to the company. As such it is tax free	• Must have transferred assets to the corporation or paid corporate expenses personally in order to create the loan. • Shareholder loan payments are not a deduction for the company
Rental payments for use of personal assets	• Rental payments can be used to make RRSP contributions, but CPP is not required to be paid on them • Rental payments are a deduction for the corporation	• Rental rate must be reasonable • Shareholder must continue to hold personal assets

CONCLUSION

Incorporation is an increasingly popular business structure for farm business. Business owners should take the time to discuss the options with their advisors to determine if a corporate structure will help them achieve their business and family goals.

This Factsheet was written **by Rob Gamble**, BSc. (Agr), MTax, Finance and Business Structures, Program Lead, Agriculture and Rural Division, OMAFRA, Guelph.

This Factsheet is intended as general information and not as specific advice concerning individual situations. Although it outlines some of the financial and legal considerations of incorporation, it should not be considered as either an interpretation or complete coverage of the *Income Tax Act* or the *Business Corporations Act of Ontario* or any other laws affecting incorporation. The Government of Ontario assumes no responsibility towards persons using it as such. Discuss all options with your lawyer and tax advisor before

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